EDMONTON

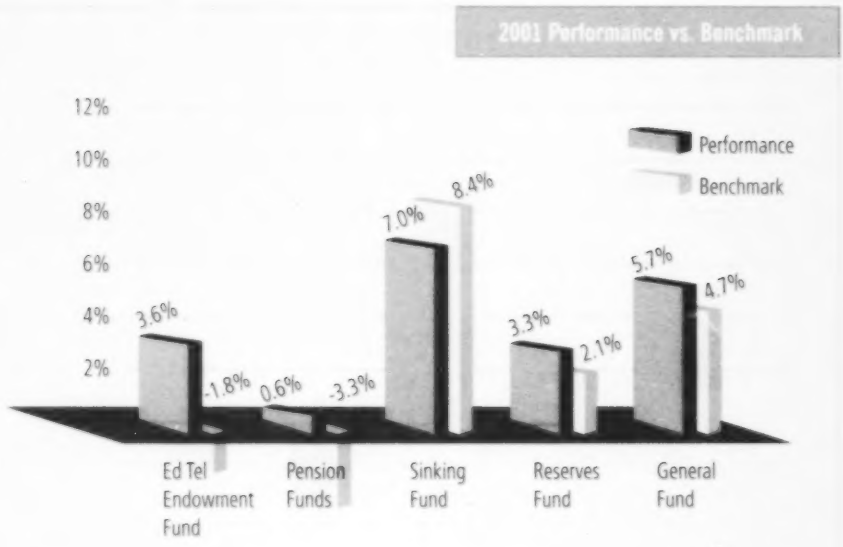
2001 Investment Committee ANNUAL REPORT

Overview

We are pleased to report that in a year that was very difficult for investors the City of Edmonton achieved positive rates of return for all investment funds.

In what was already proving to be a year of poor investment returns, the unfortunate events of September 11th had a significant impact on financial markets worldwide.

All of the major equity markets posted negative returns for the year (see Capital Market Returns on page 2). In contrast to the equity markets, bond markets performed well. The strong bond market returns partially offset the negative equity returns and reinforced the value of diversification across various asset classes.



Performance Benchmarks

- A benchmark is a "return target comparison" used to evaluate the effectiveness of an investment program.
- The following are the specific asset class benchmarks referred to throughout this report:
  - **Short Term (Cash):** Scotia Capital Markets 91 Day Treasury Bill Index (91 day t-bill)
  - **Bonds:** Scotia Capital Markets Universe Bond Index (SCMU)
  - **Canadian Equities:** Toronto Stock Exchange 300, Nesbitt Burns Capped 10%, Total Return Index (TSE 300, Capped 10%)
  - **US Equities:** Standard & Poors 500 (S&P 500)
  - **Foreign Equities:** Morgan Stanley Capital Inc. Europe, Austral-Asia, Far East Index (MSCI EAFE)
  - **Global Equities:** Morgan Stanley Capital Inc. World Index (MSCI World)
- The "Total Fund benchmark" consists of the above indices weighted by the Policy Asset Mix. This is used for evaluating the investment performance of the 'Total Fund."

Performance

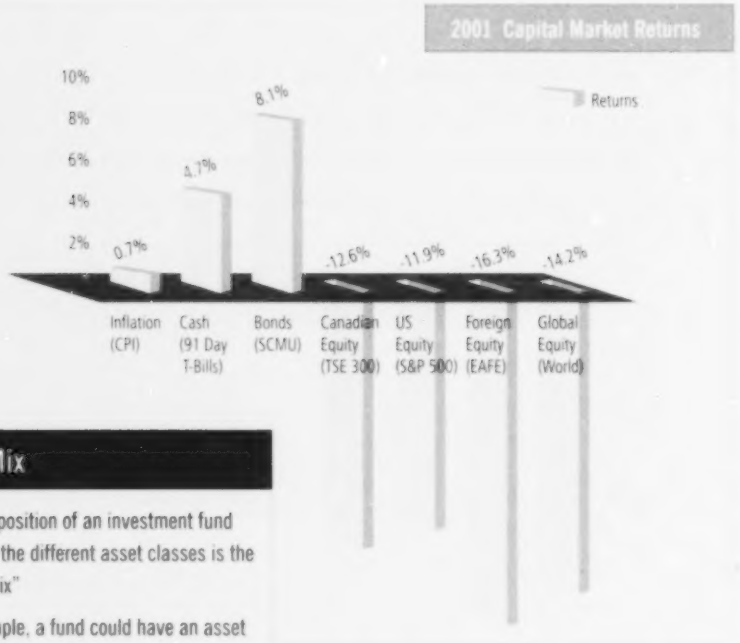
Looking at the performance of each of the funds monitored by the Investment Committee, with the exception of the Sinking Fund, all of the funds outperformed their benchmarks for the calendar year 2001. On the more important four-year basis, again all of the funds outperformed their benchmarks with the exception of the Sinking Fund. The under performance of the Sinking Fund is primarily due to the use of a benchmark that was not appropriate for the investment strategy employed. The benchmark was changed with the approval of Investment Policy C212B in March 2001.

The Investment Committee is pleased with the outperformance versus the benchmarks, but cautions that this outperformance should not be expected on a regular basis. The City's investment managers ensure prudent diversification and were not as exposed to Nortel Networks and the technology sector collapse as the benchmark and many other investors were.

Compliance

A key role of the Investment Committee is ensuring that the City's investments are managed in compliance with the City's investment policy and all relevant legislation.

There was only one issue of non-compliance to report. The Ed Tel Endowment Fund ended the year with an allocation to fixed income of 43.8 per cent versus 43 per cent, the maximum allowed under Investment Policy C212B. The fixed income allocation was gradually reduced over the course of the year and was below the policy maximum by January 31, 2002. The other investment activities of the City's funds were in compliance with the City's policies and all statutory requirements.



Asset Mix

- The composition of an investment fund between the different asset classes is the "Asset Mix"
- For example, a fund could have an asset mix of 5% cash, 35% bonds, 30% Canadian equity and 30% global equity
- The "Policy Asset Mix" is the "long term target asset mix" of the fund, as stated in the Investment Policy. This mix, over a long period of time, should allow the fund to meet its explicitly stated "investment objectives". Over shorter time periods the returns may fall short or exceed the investment objectives.
- There are often "allowed ranges" around the target asset mix to allow for temporary differences as the various asset classes appreciate and depreciate over time.
- Rebalancing to the Policy Asset Mix should occur prior to a policy range minimum or maximum being breached.

Changes in 2001

2001 was a year of significant change for the City's investment management function. Following the approval of Investment Policy C212B, a new investment manager structure was implemented. Highlights of the changes are as follows:

- The City of Edmonton Master Trust was established to consolidate the active Canadian equity assets and the active fixed income assets. The Master Trust works a lot like a mutual fund; each of the City's funds contributes assets or cash to the Master Trust and receives units in exchange. The value of the units increases or decreases with the change in market value, receipt of income or dividends, etc. The Master Trust provides consistent performance and significant cost savings through economies of scale. The Master Trust allows for the consolidation of assets from the Reserves Fund, Pension Funds, and Ed Tel Endowment Fund for management purposes while keeping them separate for accounting purposes.
- An allocation to passive (index fund) investment strategies was implemented for the Reserves Fund, Ed Tel Endowment Fund and the Pension Fund. The passive strategies greatly lower management expenses and reduce the chance of underperforming the equity and fixed income benchmarks. The size of the allocation to passive investments is different for each asset class depending on its history and perceived opportunities for outperformance from active management.

- As a result of the new structure, four of the companies that previously managed assets were retained, three had their mandates terminated, and three new managers were hired.

In addition to the new investment manager structure, the following also occurred in 2001:

- The management of the Sinking Fund was changed from external to internal management. With the addition of the Sinking Fund, the Investment Management Section internally manages approximately $800 million in fixed income assets. The increased internal management will significantly lower the investment management expenses.
- A proxy voting service was hired to implement the responsible proxy voting criteria in Investment Policy C212B.

Active Management

- Active managers try to outperform performance benchmarks.
- This is done by selecting securities believed to be superior to those in the benchmark index.
- The selection of securities is usually based on a specific theory or investment style.

Passive Management

- Passive managers fully replicate (by buying the same securities in the right proportion) a broad market index such as the TSE 300 or S&P 500.
- This ensures returns are virtually the same as the published index returns. It minimizes the risk of underperformance, but correspondingly, also means there is less opportunity for outperformance.
- Fees and expenses are significantly lower than for active management.

The Future

Following a year of significant change, 2002 is being approached as a year of consolidation, with a focus on operational fine-tuning and evaluating the effectiveness of the changes that were implemented in 2001. The one exception is the Reserves and Working Capital Investment Review that was planned for 2001 but has been carried over to 2002.

The following sections provide details on each of the respective funds.

External Investment Managers

With the new investment manager structure, the **Reserves Fund**, **Ed Tel Endowment Fund** and the **Pension Fund** share the same external investment managers.

Fund Managers:

Canadian Equity
- AMI Partners Inc.
- Greystone Managed Investments Inc.
- TD Asset Management Inc.

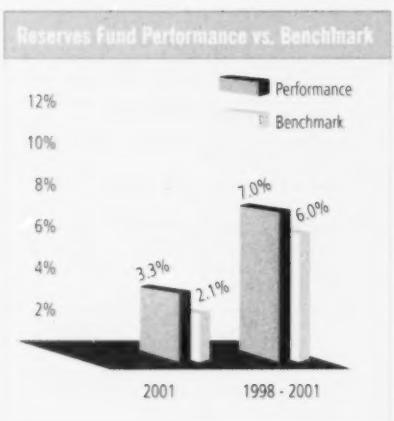
Canadian Fixed Income
- Phillips Hager & North Investment Management Ltd.
- Perigee Investment Counsel Inc.
- TD Asset Management Inc.

US Equity
- TD Asset Management Inc.

EAFE Equity
- Lazard Asset Management Inc.
- Fidelity Investments

Reserves Fund

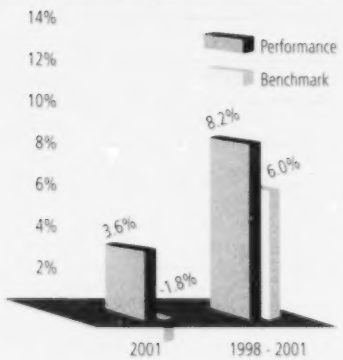
- The purpose of the Reserves Fund is to provide an investment vehicle for funds with a longer time horizon and a risk tolerance that permits owning equities. Eligible funds include operating and capital reserve funds, deferred revenue accounts, portions of the General Fund and other similar mandated funds.
- **The Reserves Fund achieved a compound rate of return of 7.0 per cent over the last four years, outperforming the benchmark return of 6.0 per cent. For 2001, the fund earned a 3.3 per cent return, also outperforming the benchmark, which returned 2.1 per cent.**
- At December 31, 2001 the Reserves Fund had a market value of $326 million.



Ed Tel Endowment Fund

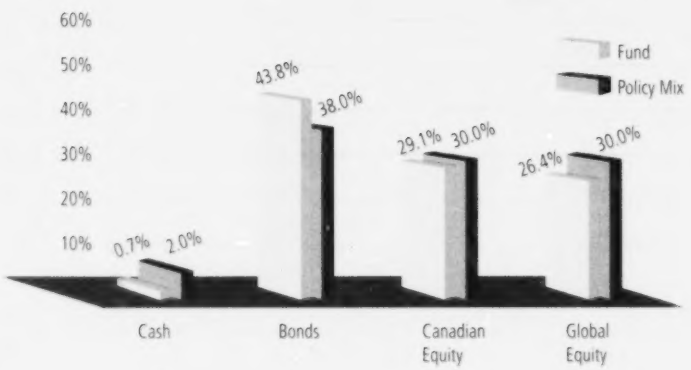
- The Ed Tel Endowment Fund was created in 1995. It holds the financial assets generated by the sale of Edmonton Telephones to the Telus Corporation. The fund's purpose is to provide an income source for the City and to provide a financial legacy for future generations.
- **The Ed Tel Endowment Fund has outperformed both its one-year and four-year performance targets. The annual compound return over the four years from 1998 to 2001 was 8.2 per cent vs. the policy benchmark of 6.0 per cent. The 2001 annual return was 3.6 per cent vs. the benchmark return of -1.8 per cent.**

Ed Tel Endowment Fund Performance vs. Benchmark



- **Exceeding the benchmark return by this margin is a rare occurrence.** This outperformance can be attributed to strong performance from the active Canadian equity managers and to the Investment Committee's decision to limit the maximum equity investment in any one company to 10 per cent.

Ed Tel Endowment Fund Asset Mix vs. Policy Mix

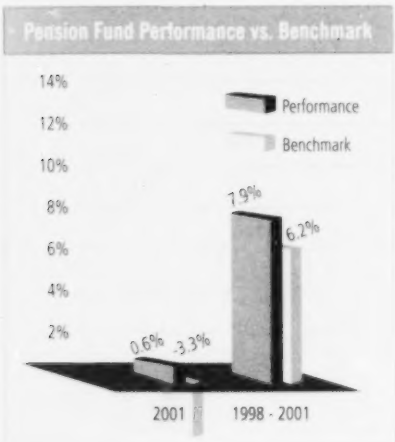


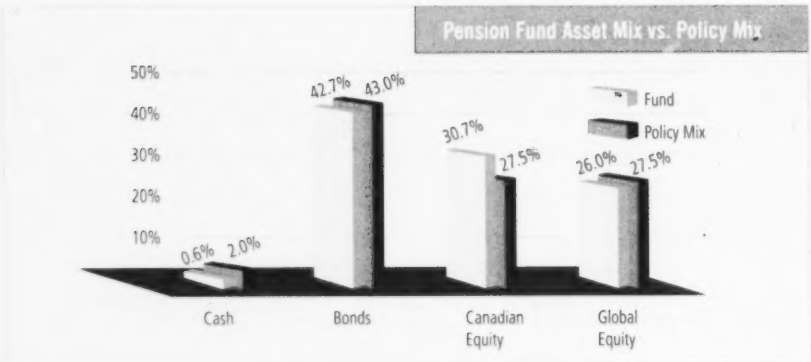
Ed Tel Endowment Fund Market Value vs. Inflation Indexed Principal

- The asset mix for the fund was changed in 2001 to 60 per cent equity from 40 per cent. This shift was made gradually over the course of 2001 and was nearly completed by year-end.
- As can be seen in the Market Value vs. Inflation Indexed Principal Chart, the retained earnings in the fund were reduced in 2001. This reduction was a result of the Fund earning a rate of return (3.6%) that was not high enough to cover the annual withdrawal. At December 31, 2001 the retained earnings balance was $66 million. Over the long term, the fund needs a rate of return of approximately 7.5 per cent to provide the annual withdrawal and grow the principal with inflation. **If the fund experiences a second consecutive year of low absolute returns, the amount of the annual withdrawals may have to be reviewed.** The relatively high return requirement necessitated the asset mix change to 60 per cent equities, which should provide a higher return over the long term.
- At December 31, 2001 the fund had a market value of $588 million. The fund was established in 1995 with $465 million. In addition to the growth in value of the fund, it has paid dividends to the City of $268 million from 1995 to 2001.

Pension Fund

- This fund consists of the Firefighters Supplemental Fund, the Fire Chiefs and Deputy Fire Chiefs Supplemental Fund, and two other small mature pension funds with only a few beneficiaries. Over time the smaller plans will be wound up.



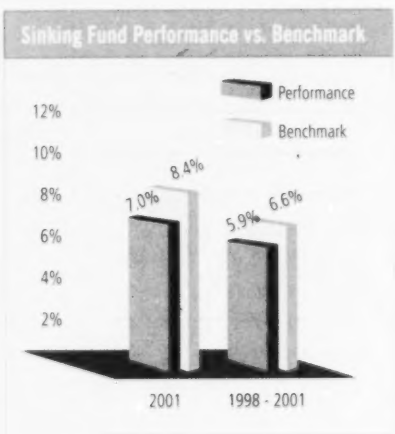


- In 2001, the Pension Fund returned 0.6 per cent, which outperformed the benchmark return of -3.3 per cent. **The Pension Fund also outperformed its four-year benchmark with a return of 7.9 per cent while the benchmark return was 6.2 per cent.**
- At year-end 2001, the market value of the Pension Fund was $115 million.

Sinking Fund

Fund Manager: City of Edmonton Investment Management Section

- The Sinking Fund has existed since the incorporation of the City of Edmonton. The fund was established to fulfill the requirements of various public debenture issues (borrowings) requiring funds be set aside regularly for the eventual redemption of these debenture issues. There are currently 13 outstanding debenture issues for which the Sinking Fund is accumulating assets. These debenture issues mature from 2003 to 2018.
- In July 2001 the City of Edmonton Investment Management Section assumed responsibility as the fund manager for the Sinking Fund.
- During the year 2001, the Sinking Fund returned 7.0 per cent vs. the benchmark return of 8.4 per cent. On a four-year basis, the fund earned an annual rate of return of 5.9 per cent vs. the benchmark return of 6.6 per cent. **For the six months since moving to a new management strategy, internal management and a more appropriate benchmark, the Sinking Fund has returned 7.5 per cent versus 7.1 per cent for the benchmark.**



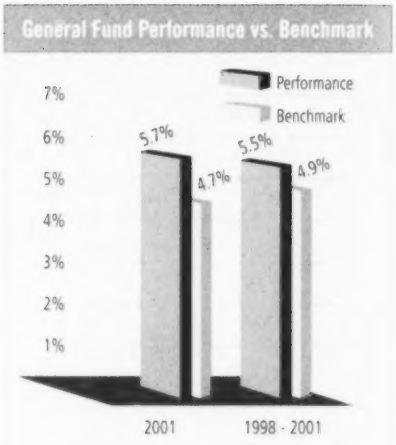
- At year-end 2001, the Sinking Fund had a surplus balance of $55.4 million. The surplus is split between the City and EPCOR. $27.4 million belongs to the City, and $28 million to EPCOR. All future surplus earnings will be split 50:50 between the City and EPCOR. During 2001, $9.3 million was withdrawn from the fund and transferred to operating funds. Currently, a further $20.2 million is budgeted to be withdrawn over the next three years.
- At December 31, 2001 the market value of the Sinking Fund was $512 million. It is made up entirely of fixed income securities (98.4 per cent bonds, 1.6 per cent cash). It has no Canadian or foreign equity.

Working Capital Funds

General Fund

Fund Manager: City of Edmonton Investment Management Section

- The General Fund represents the excess or shortfall in the daily operating funding requirements of the City. The purpose of the fund is to ensure that sufficient cash and liquid assets are available to cover the City's short-term obligations.
- **The General Fund outperformed the benchmark on both a one-year (5.7 per cent vs. 4.7 per cent) and four-year (5.5 per cent vs. 4.9 per cent) basis.**
- In 2001 a further $25 million was invested in bonds bringing the total to $97 million. This was done to take advantage of higher bond yields compared to very low rates available from short-term money market instruments. This bond portion contributed significantly to the fund's outperformance.
- The General Fund had assets totaling $133 million as at December 31, 2001. The City's significant revenue streams are cyclical, and the fund reaches a peak each July of approximately $375 million.



Transportation Fund

Fund Manager: City of Edmonton Investment Management Section

- The Transportation Fund was established in March 2000 with the receipt of fuel tax grants from the Province of Alberta. The agreement with the Province stipulates that the funds:
  - be used for approved projects,
  - are kept separate from other City funds, and
  - that the investment earnings are kept in the fund and applied to approved projects.
- $130 million was received on March 31, 2000 and $52.7 million on June 30, 2000. This represents an estimate of the fuel grants from April 1, 2000 to March 31, 2003. Because the grant money was given in advance it was discounted at an annual rate of 4.75 per cent.
- The primary objective in managing this fund is to meet or exceed the 4.75 per cent discount rate.
- For 2001, the Transportation Fund returned 7.3 per cent. **Since the fund was started on March 31, 2000, an annualized rate of return of 7.6 per cent has been realized, which is well in excess of the 4.75 per cent discount rate applied by the Province.** The Transportation Fund had a market value of $120 million at December 31, 2001.

Ed Tel Defeasance Fund

Fund Manager: City of Edmonton Investment Management Section

- This fund was created in December 1999 as a result of the Telus Corporation's decision to pay the old Ed Tel debt in kind by using a portfolio of bonds. These bonds mature at the same time that the City's outstanding debt comes due. The final payment from the fund is on November 1, 2004.
- This fund was created solely for the purpose of retiring the old Ed Tel debt. There is very little activity in this fund except on the rare occasions when it is possible to replace existing securities with ones that provide a higher yield while maintaining the same term to maturity.
- The Ed Tel Defeasance Fund had a market value of $30 million at December 31, 2001.

EPCOR – *An Investor's Perspective*

As an "investor" in EPCOR, the City looks for:

- financial performance
- good governance, and
- risk management.

Financial Performance

A comparison between EPCOR and other Canadian energy companies demonstrates that this investment has performed well for the City.

Financial Information and Ratio Analysis

Company	Total Assets	Debt Level	Net Inc	ROE
Atco Ltd	$5,740	33%	$119	13%
BC Gas*	$3,704	52%	$85	11%
Cdn Utilities	$5,379	35%	$220	14%
Emera*	$3,959	35%	$114	10%
Fortis	$1,563	43%	$58	13%
TransAlta*	$4,927	31%	$215	9%
Average	$4,212	38%	$135	12%
EPCOR 2001*	$4,540	36%	$227	17%
EPCOR 2000	$3,093	38%	$149	16%

*calendar 12 months (otherwise nine months)

In terms of assets, EPCOR has climbed to 4th place, surpassing Emera Inc. and BC Gas Inc. Its net income has vaulted EPCOR from 4th place in 2000 to 1st place in 2001.

What this means is that EPCOR has broadened its scope over the last two years and has performed well, evidenced by the growth of assets and net income. The challenge will be to continue to grow net income.

The role the current electrical energy marketplace plays is that while energy "prices" are down today, energy bills are still high as consumers pay for previous years' high energy costs. Energy utility companies can still perform satisfactorily in a lower price environment.

Good Governance

In a post-Enron world, the standards for governance and the quality of financial disclosure are increasing. As indicated in the customized governance checklist (see chart to the right), City Council has established an excellent system of accountability checks and balances. These should ensure that EPCOR is managed on the basis of providing the lowest possible power rates for the ratepayers and generating a reasonable dividend and return on investment for the shareholder.

Transparent rate setting process	✓
Board of Directors operate independent of City Council	✓
Chairman independent of Company management	✓
Audit Committee controlled by outside directors	✓
Corporation has a Governance Committee & Policy	✓
Board of Directors focused on maximizing shareholder wealth as well as identifying & controlling risks	✓
Corporation is committed to environmental responsibility	✓
Shareholder appoints external auditors & directors	✓
Shareholder sets dividend policy	✓
Independent performance review (Investment Committee)	✓

Risk Management

While EPCOR's risk management program mitigates some risks, the result of deregulation is that the company faces higher business risks across certain sectors (energy & retail). Energy, including existing regulated and new unregulated generation, represents the highest risk. The failure of a generating plant tied to long-term power commitments could result in EPCOR having to deliver higher priced energy purchased on the volatile spot market. This could result in losses for that portion of the outage or losses that were not covered by "business interruption" insurance maintained by the corporation or the "force majeur" provisions of the underlying power purchase arrangements.

Uninsured prolonged downtime for major repairs, higher interest rates, or other business risks could also impair earnings and result in a downgrade by credit rating agencies, resulting in higher interest costs. Extreme events could result in further downgrades and loss of EPCOR's investment grade status, which would shut EPCOR out of the debt markets. If this were to happen, so long as EPCOR does not have access to equity markets, the City becomes the lender of last resort. While this scenario has a low probability, the size of the City's investment in the company makes this somewhat of a risk for the City.

Final Remarks

While presenting the City with a different set of risks, EPCOR achieves satisfactory marks in terms of financial performance, governance and risk management practices. EPCOR is performing well from an investor's perspective.

Responsible Proxy Voting

- Owning common stock confers certain rights. These include the right to propose and vote on corporate policies through the shareholder resolution process (proxy voting).
- The Investment Policy C212B contains a commitment for the City of Edmonton to promote social and ethical business practices through proxy voting.
- Following the approval of Investment Policy C212B in 2001, the Administration has retained a proxy voting service to vote the City's ballots for the hundreds of companies in which the City owns shares. The voting service implements the City's policy through careful analysis of each voting issue.
- The majority of voting activity occurs in conjunction with corporate annual meetings that are typically scheduled for April or May. The City's proxies will be voted with the new policy criteria for the 2002 annual meeting season.

Governance and Operating Structure of the Investment Committee

Governance is extremely important as it ensures those who are best qualified are the ones making the required decisions. It assures the citizens that their City government takes the management of investment funds very seriously. It also assures taxpayers that policies, processes, procedures and controls are being developed to maximize returns at a prudent level of overall risk.

Responsibilities of City Council

The role of City Council as governing fiduciaries is to periodically receive reports and recommendations from the City Manager and approve the Investment Policy.

The Investment Policy establishes each fund's:

- investment objectives
- investment beliefs
- permitted investment categories
- asset allocation (policy mix and permitted ranges)
- performance benchmarks
- allowable implementation strategies
- proxy voting guidelines
- monitoring and controls
- reporting requirements

The Investment Committee

The Investment Committee was established by the City Manager to oversee the investment of the City's financial assets.

The roles and responsibilities are clearly defined in the Investment Committee Terms of Reference. The key responsibilities are to:

- Review the Investment Policy and Terms of Reference and recommend changes as necessary.
- Review investment strategies, capital market assumptions, manager structure, services of external managers and other consultants.
- Monitor all reported investment activities for compliance with City policy and statutory requirements.
- Meet with external investment managers, performance measurement advisors, external auditors and other consultants as required.
- Monitor investment performance vs. established performance benchmarks.
- Monitor proxy voting activity.
- Review reports on the performance of EPCOR from an investor's perspective.
- Assist the Chief Financial Officer in preparing an annual report on investment performance and compliance for recommendation to the City Manager and City Council.

Investment Committee

Randy Garvey *Chairperson*
Ernie Mulyk *Secretary*
Peter Crosman
Emilian Groch
Bob Grose
Blake Walker
Beverly Wittmack